FOREIGN DIRECT INVESTMENT (FDI) FLOWS AND SUSTAINED GROWTH: A CASE STUDY OF INDIA AND CHINA

***Dr. ARABI. U.**

Introduction

Increasing integration of countries through growing volumes of trade and capital flows has been a characteristics feature of the world economy in recent times. Greater openness to trade and capital flows entailing greater interdependence among economies as long moved on from the realms of theoretical debate to that of inevitability. Indeed, the decades of 1980's and 1990's have witnessed a generalized shift in policy stance towards openness among a number of emerging market economies either spontaneously so as to reap the benefits of greater volumes of trade and external investment or under the compulsions arising out of unsustainable domestic imbalances. These two decades however, have also seen a series of financial crisis in several open economies engendered by volatile capital flows prompting a re-look into the conventional wisdom regarding the gain from cross-border trade and investment. This has brought to the fore a number of open-ended issues relating to the manner and sequencing of such opening up, the challenges posed by true capital flows and increased cross border market integration and the role of monetary and fiscal policies in sustaining economic growth in FDI recipient economies.

Access to international capital enables a country to supplement domestic savings and smooth inter-temporal consumption. This could strengthen the growth process and foster employment generation in the recipient country. The actual impact of capital flows on economic growth is undoubtedly an empirical issue and varies widely across countries. An increase in capital flows is expected to augment domestic savings and investment, boost aggregate demand savings and investment, boost aggregate demand and lead to an increase in aggregate output and income

Most developing countries consider FDI as an important channel for accessing resources for economic development. FDI represents transfer of a bundle of assets like capital, technology, and access to export markets, skills and management techniques and modern environment management system. FDI inflows are necessary, but not sufficient of globalization. Over the last two decades there has been a change in the approach towards assessing the impact of FDI flows on the recipient economy. In the earlier approaches, the impact of FDI on growth was found to be limited in the short-run since long-term growth was largely considered to be contingent upon technological progress

(Grossman and Helpman, 1991). On the other hand, according to the more recent endogenous growth theory, FDI is considered as a composite of capital, know-how and technology (Balasubramanyam et al., 1996). Under this approach, FDI can have a permanent positive impact on economic growth by generating increasing returns to scale through externalities and positive productivity spillovers (de Mello, 1997). The positive impact of FDI is expected to encourage through the use of new inputs and technology in the recipient economy, in addition, FDI or even purely technical change in managements in the recipient developing countries (de Mello and Sinclair, 1995).

Empirical investigations have found that the positive impact of FDI is generally higher for recipient countries with a higher level of development (Blomstorm et al., 19940). Such findings support the arguments that in the absence of a minimum threshold level of development, the positive impact of FDI would remain confined to particular FDI enclaves of the economy (Borensztein et al., 1995). Moreover, the benefits of FDI can be realized fully only if the economy's saving rate is less than domestic investment, i.e., in the context of a current account deficit. On the other hand, if the absorptive capacity of the economy is weak, higher FDI inflows could end up in higher foreign exchange reserves. The spillover effect of FDI is also found to be the highest in industries with high level of technical development and low concentration of foreign firms. Indigenous technology capabilities have been found to be positively associated with technology import, research and development in the recipient country, output growth and manufacturing exports (Zhao, 1995). Some studies have found that compared with firms under pure domestic ownership, FDI firms generally have higher capital intensity, exports to sales ratio and imported input component (O' Sullivan, 1993). There is, however, a tendency of technology imports to shift from physical capital –intensive to human capital-intensive type over time. The economic benefits of FDI are generally difficult to measure with precision. However, it may be noted that, a liberal policy towards FDI inflow is necessary, but not sufficient for reaping the benefits of globalization. Market failures may occur for attracting FDI flows.

Though there is no ideal strategy for the use of FDI as applicable to all countries at all times, a good strategy must be context specific, reflecting a county's level of economic development, the resource base, the specific technological context, the competitive setting, and the Government's capabilities to implement policies. For instance, countries like Malaysia, Singapore and Thailand pursued policies to rely substantially on FDI, while integrating the economy into Transnational Corporations (T N Cs) production networks and promoting competitiveness by upgrading within those networks. On the other hand, countries like, China, Korea etc. has pursued policies to develop domestic enterprises and autonomous innovative capabilities, relying on TNCs mainly as sources of technology.

Trends in Global FDI Flows:

Most FDI has been directed towards the developed world, although the share of developing countries had been growing steadily until 1997, when it reached a peak of around 40% (Table.1). The important characteristics feature of FDI flows to Emerging Market Economies (EMEs) in the 1990s were, Firstly, there was a rapid increase in

Table.1. FDI Inflows by Host Region and Economy (U.S. $ Billion)

(Figures in brackets indicate percentage to the total)

Host	1991-1996						

Region/Economy	(Average)	1997	1998	1999	2000	2001	2002
WORLD (% to total)	254.3 (!00)	481.9 (100)	686.0 (100)	1097.1 (100)	1393.0 (100)	823.8 (100)	651.2 (100)
Developed Economies	154.6 (60.8)	269.7 (56.0)	472.3 (68.8)	824.6 (76.4)	1120.5 (80.4)	589.4 71.5	460.3 (70.7)
Central and Eastern Europe	8.2 (3.2)	19.0 (3.9)	22.5 (3.3)	25.1 (2.3)	26.4 (1.9)	25.0 (3.0)	28.7 (4.4)
Developing Economies	91.5 (36.0)	193.2 (40.1)	191.3 (27.9)	229.3 (21.2)	246.1 (17.7)	209.4 (25.4)	162.1 (24.9)
Of which:							
Latin America and the Caribbean	27.1 (29.6)	73.3 (37.9)	82.0 (42.9)	108.3 (47.2)	95.4 (38.8)	83.7 (40.0)	56.0 (34.5)
Argentina	4.3 (4.7)	9.2 (4.7)	7.3 (3.8)	24.0 (10.5)	11.7 (4.7)	3.2 (1.5)	1.0 (0.6)
Brazil	3.6 (4.0)	19.0 (9.8)	28.9 (15.1)	28.6 (12.5)	32.8 (13.3)	22.5 (10.7)	16.6 (10.2)
Chile	2.2 (2.4)	5.3 (2.7)	4.6 (2.4)	8.8 (3.8)	3.6 (1.5)	4.5 (2.1)	1.6 (1.0)
Colombia	1.3 (1.4)	5.6 (2.9)	2.8 (1.5)	1.5 (0.6)	2.2 (0.9)	2.5 (1.2)	2.0 (1.3)
Asia	59.4 (64.9)	109.1 (56.5)	100.0 (52.3)	108.5 (47.3)	142.1 (57.7)	106.8 (51.0)	95.0 (58.6)
China	25.5 (27.8)	44.2 (22.9)	43.8 (22.9)	40.3 (17.6)	40.8 (16.6)	46.8 (22.4)	52.7 (32.5)
Hong Kong, SAR	6.1 (6.6)	11.4 (5.9)	14.8 (7.7)	24.6 (10.7)	61.9 (25.2)	23.8 (11.4)	13.7 (8.5)
India	1.2 (1.3)	3.6 (1.9)	2.5 (1.3)	2.2 (0.9)	4.0 (1.6)	6.1 (2.9)	4.7 (2.9)
Indonesia	3.0 (3.3)	4.7 (2.4)	-0.4 (-0.2)	-2.7 (-1.2)	-4.6 (-1.8)	-3.3 (-1.6)	-1.5 (-0.9)
Korea, Republic Of	1.2 (1.3)	2.8 (1.5)	5.4 (2.8)	9.3 (4.1)	9.3 (3.8)	3.5 (1.7)	2.0 (1.2)
Malaysia	5.4 (5.9)	6.3 (3.3)	2.7 (1.4)	3.9 (1.7)	3.8 (1.5)	0.6 (0.3)	3.2 (2.0)
Philippines	1.2 (1.3)	1.3 (0.7)	1.7 (0.9)	1.7 (0.8)	1.3 (0.5)	1.0 (0.5)	1.1 (0.7)
Singapore	6.9 (7.5)	13.5 (7.0)	7.6 (4.0)	13.2 (5.8)	12.5 (5.1)	10.9 (5.2)	7.7 (4.7)
Taiwan, Province Of China	1.3 (1.4)	2.2 (1.2)	0.2 (0.1)	2.9 (1.3)	4.9 (2.0)	4.1 (2.0)	1.4 (0.9)
Thailand	2.0 (2.1)	3.9 (2.0)	7.5 (3.9)	6.1 (2.7)	3.4 (1.4)	3.8 (1.8)	1.1 (0.7)

Source: World Investment Report, UNCTAD, 2003. Reserve Bank of India. (2004)

FDI inflows in the 1990s, owing largely to the adoption of macroeconomic and structural reforms by a number of these countries and the strengthening of their growth prospects.

Secondly, the surge in FDI, especially in the latter of the 1990s, was led by increased merger and acquisition activity. Thirdly, for a number of countries there was a significant shift of FDI into the service sector in tandem with the increasing share of services activities in these host countries. In fact, traditionally, FDI was directed towards the development of natural resources and manufacturing enterprises.

Most of the recent studies conclude that FDI is a relatively stable type of capital flow (Radelet and Sachs.1998). During the period 1992-97, commercial bank loans displayed the highest volatility, as measured by the coefficient of variation, followed by portfolio investment and FDI. Another study in respect of 12 major developing economies and countries in transition for the same period, based on annual data, confirmed that the volatility of foreign portfolio investment was generally higher than that of FDI (UNCTAD, 1998). Further, FDI flows continue to be concentrated in China, Hong Kong (China) and Singapore. The top 10 host economies took 93% of the regions total inflows in 2002. Further, FDI flows to North-East Asia 16 dropped from $78 billion in2001 to $ 70 billion in 2002. FDI flows to Hong Kong (China) fell by 42%, to Taiwan Province of China by 65% and to the Republic of Korea by 44%, partly because TNC production activities were relocated to lower cost locations, primarily China. The decline in FDI flows was also partly due to slow economic growth of these economies. The notable exception was China, FDI flows to South-East Asia dropped from $15 billion in 2001 to $14 billion in 2002, through Brunei Darussalam, Lao People's Democratic Republic, Malaysia and the Philippines received larger flows than in 2001. Significant repayments of intra-company loans by foreign affiliates were a feature of the decline, as was the increased competition from China. FDI flows to South Asia increased from $4.0 billion in 2001 to $4.6 billion in 2002, due to higher flows to India, Pakistan and Sri Lanka. FDI flows to Bangladesh and other countries in the sub region declined. However, in the case of Bangladesh, FDI flows in 2002 would have been higher if investment in kind were included. FDI flows to West Asia declined in 2002 to $ 2.3 billion, from $ 5.2 billion in 2001. Despite the recent efforts of some countries in this sub region to relax FDI restrictions, flows continue to be low, with geopolitical tensions being a major factor. Some countries have large oil reserves with after reaching a peak in 2000, global FDI inflows declined in the subsequent years. In 2002, a handful of countries like China, Brazil, Hong Kong, Mexico, Singapore, India and Malaysia accounted for around 70% of total FDI flowing into developing countries (Table.1).The source of FDI in East Asia has predominantly been the region within itself-Hong Kong and Taiwan together account for about 45% of FDI in the major recipient countries in the region including China. These two source are inseparable, since a significant amount of investment from Taiwan is channeled through Hong Kong and they together account for almost 70% of FDI in China. After the East Asian Newly Industrialized Economies (NIEs), Japan ranks as the second largest investor in the region-its investments are spread more or less equally between China, Malaysia and Thailand.

Foreign Direct Investment in China and India:

The IMF definition of FDI includes as many as twelve different element-equity capital reinvested earning of foreign companies, inter-company debt transaction, short-term and long-term loans, financial leasing trade credits grants bonds, on-cash acquisition of equity, investment made by foreign venture capital investors, earning data of indirectly held FDI enterprises, control premium and non-competition fee. Until recently, Indian

data on FDI did not include any other element other than equity capital reported on the basis of issue or transfer of equity or preference shares to foreign direct investor. China on the other hand, includes all these in its definition of FDI. China also classified imported equipment as FDI, whereas India includes these as imports in its trade data. After the incorporation of new items, FDI inflow into India during 2001-02 where revised upwards by US $ 1.7 billion and US $ 2.2 billion, respectively. However, even after adjusting for round tripping in china and considering the new FDI data for India at US $ 6 billion, respectively, in 2001 continues to remain considerable. In this context, it is also important to point out that India receives large private transfers in the forms of remittance inflows from non-residents and also capital inflow in the form of NRI deposits. In recent times, gross workers' remittances to India per annum have been around US $ 3 billion. Inflow to china from Chinese Diaspora, on the other hand, is recorded largely as FDI. Recent literature suggests that domestic market size is a major factor in including FDI inflow (IMF, 2003). At present, the Chinese economy is two and a half times that of the Indian economy while per capita income is twice as high. The growth induced local demand for durables and non-durables, competitive business environment, wage-adjusted productivity of labour, higher literacy, better infrastructure and education rates drive the efficiency seeking investors to China (UNCTAD, 2003). FDI in China is also driven by 'peer pressure' since many firms have followed their competitors into China to pressure their significant investment in mainland China , the overseas network and investment **in** India are much smaller (Bhalla, 2002).

India and China received large FDI flows in the 1990s. FDI flows to China are, however, ten times of that in respect of India (Table.2). The timing, pacing and content of FDI liberalization and the overall development strategy in the two countries seem to account for the difference in FDI performance. In UNCTAD's FDI Performance Index, India ranked 122nd in FDI performance. China was placed much higher at the 54th position. A recent business environment survey indicated that China is more attractive than India in terms of the macroeconomic environment, market opportunities and policy orientation towards FDI. India, on the other hand, scored better on the political environment, taxes and financing (EIU, 2003).

Table.2. China and India: Selected FDI indicators

Item	Country	1990	2000	2001	2002
1.FDI Flows (US.$ billion)	China India	3.5 0.1	40.0 4.0	46.8 6.1	52.7 4.7
2.Inward FDIStock(US$ billion)	China India	24.8 1.5	348.3 21.0	395.2 27.1	447.9 31.8
3. Growth of FDI Inflows (Annual %)	China India	2.8 -76.3	1.1 97.0@	14.9 52.2	12.5 -24.0
4. FDI Stock to GDP (%)	China India	7.0 0.5	32.3 4.5	33.2 5.6	36.2 6.2
5.FDI Flows to Gross Fixed	China India	3.5 0.1	10.3 3.9	10.5 5.8	 N.A

Capital Formation (%)					
6. FDI Flows per Capita (US $)	China India	3.0 0.1	32.0 3.9	36.5 5.9	40.7 4.5

@: The large increase is due to change in definition.

***Source**: World Investment Report (UNCTAD) 2003, Reserve Bank of India (2004)*

A Federation of Indian Chambers of Commerce and Industry (FICCI) survey suggests that China has a better FDI policy framework, market growth, consumer purchasing power, rate of return, labour law and tax regime than India (FICCI, 2003).

China and India--Reasons for difference in FDI performance:

China's exceptional growth is partly explained by its markets –based reforms that started in 1978, well before India's similar reforms began in 1991. These reforms have enabled China to integrate with the global economy at phenomenal peace. Today it is the largest recipient of foreign direct investment among developing countries, with the annual investment rising from almost zero in 1978 to about $ 52 billion in 2002. (nearly 5% of GDP). Foreign direct investment in India has also increased significantly, though at much lower levels, growing from $129 million in 1991 to $ 4 billion in 2002 (Less than 1% of GDP**).**ed. On the way to the new economy, China is gradually becoming the world manufacturing center of IT equipment and products, while India has gained the leading position in software technology and has become the second largest software country in the world. Since mid-1990s, trading activities between the two countries greatly increased, economic cooperation, such as labor, technical cooperation and inter-investment had been widely developed. Both enjoy healthy rates of economic growth. But there are significant differences in their FDI performance. FDI flows to China grew from $3.5 billion in 1990 to $52.7 billion in 2002; if round-tripping is taken into account, China's FDI inflows could fall to, say, $40 billion Those to India rose from $ 0.4 billion to $5.5 billion during the same time period. Even with these adjustments, China attracted seven times more FDI than India in 2002, 3.2% of its GDP compared with 1.1% for India. In UNCTAD's FDI Performance Index, China ranked 54th and India 122nd in 1999-2001.FDI has also contributed to the rapid growth of China's merchandise exports, at an annual rate of 155 between 1989 and 2001. In 1989 foreign affiliates accounted for less than 9% of total Chinese exports; by 2002 they provided half. In some high- tech industries in 2002 the share of foreign affiliates in total exports was as high as 91% in electronics circuits and 96% in mobile phones (WIPR-*20O2*). About two-thirds of FDI flows to China in 2000-2001 went to manufacturing. In India, by contrast, FDI has been much less important in driving India's export growth, except in information technology. FDI in Indian manufacturing has been and remains domestic market seeking. FDI accounted for only 3% of India's exports in the early 1990s (WIPR, 20O2). Even today, FDI is estimated to account for less than 10% of India's manufacturing exports. For China the lion's share of FDI inflows in 2000-2001 went to a broad range of manufacturing industries. For India most went to services, electronics and electrical equipment and engineering and computer industries.

The differential performance of India and China in attracting the FDI inflows has been the subject of attention at the international level (UNCTAD, 2003). Further, the

difference in FDI inflows to India and China can be attributed partly to definitional and conceptual issues. For instance, a part of the difference in FDI inflow to India and China can be traced to data reporting. A sizable portion of the FDI in China is investment made by the Chinese from foreign location-the so called "round tripping"-and this takes place to a large extent due to special treatment extended by the Chinese authorities towards foreign investors' *via-a-vis* domestic investors. The round tripping is much smaller in India and takes place mainly through Mauritius for tax purposes. Estimates suggest that as 30 percent of the reported FDI in china may in fact be a result of round- tripping (UNCTAD, 2003).

Another major factor could be the earlier initiation of reform measures in China (1978) as compared to India (1991). Moreover, China's manufacturing sector productivity is 1.6 times that of India and, in some sectors, as much as five ties (Mc Kinsey, 2001). Flexible labour laws, a better labour climate and entry and exit procedures for business, business-oriented and more FDI –friendly policies also make China an attractive destination. Investors underscore the predictability and stability of the tax system as an important factor in determining investment decision. Higher Import duties on raw materials in India result in higher prices of inputs, as most domestic players resort to import parity pricing. China has a flat 17 per cent VAT rate, while India's indirect taxes range from 25 per cent to 30 per cent of the retail price for most manufactured product. The emergence of China as a member of world Trade Organization (WTO) in 2001 is a stabilizing anchor and has led to substantial liberalization in the services sector (RBI 2004).It is also important to note that India and China focused on different strategies for industrial development. India encouraged FDI only in higher technology activities, whereas China favored export-oriented FDI concentrated in manufacturing sector. China's strategy is based on the premise that an increasing proportion of international trade is inter-firm trade between multinational, and in such an environment there is no alternative to attracting FDI for export. China's FDI –driven merchandise exports grew at an annual rate of 15 percent between 1969 and 2001. In 1989, foreign affiliates accounted for less than nine percent of total Chinese exports; by 2002 these accounted for half of the exports and in high-tech industries the proportion was much higher (World Investment Report, 2003). In contrast, in India, given its product reservation policy for Small Scale Industries (SSIs), FDI is not permitted in SSI reserved products such as garments and toys, which has adverse implications for export growth. In India, exports by FDI companies grew at an average of around 9% during 1990-91 to 2001-02. A major factor in the growth of Chinese exports was the relocation of labour intensive activities by TNCs to China. However, in India this has happened mainly in the services sector. Almost all major U.S and European information technology firms have presence in India now. Foreign companies dominate India's call centre industry, with a 60% share of the annual US$ 1.5 billion turnover (World Investment Report, 2003)

Despite large FDI flows, restrictions on the organizational forms of FDI entry are still prevalent in China. For instance, in 31 industries the establishment of wholly foreign –owned enterprises is not allowed and the Chinese partners must hold majority share holdings or a dominant position in another 32 sectors (OECD, 2002). A view has been expressed that China's large absorption of FDI is not necessarily a sigh of the strength of its economy; instead, it may be a sigh of some, rather substantial, distortions (Huang, 2003). It is argued that FDI plays a major role in the Chinese economy due to systematic

and pervasive discrimination against efficient and entrepreneurial domestic firms. Furthermore, unlike India, a vibrant private sector is absent in China and most of the foreign investors must perform tie up with only state owned behemoths for joint ventures.

Basic determinants:

On the basis of economic determinants of inward FDI, China does better than India. China's total and per capita GDP are higher making it more attractive to efficiency-seeking investors (World Bank 2003c, p. 234; UNDP 2002). China also has large natural resource endowments. In addition, China's physical infrastructure is more competitive, particularly in the coastal areas (CUTS 2003, Marubeni Corporation Economic Research Institute 2002). But, India may have an advantage in technical manpower, particularly in information technology. It also has better English Language skills.

Some of the differences in competitive advantages of the two countries are illustrated by the composition of their inward FDI flows. In information and communication technology, China has become a key center for hardware design and manufacturing by such companies as Acer, Ericsson, and General Electric,-Hitachi Semiconductors, Microsoft, Mitac International Corporation, Motorola, NEC, Nokia, Philips, Samsung Electronics, Sony, Taiwan Semiconductor Manufacturing, Toshiba and other major electronics TNCs . India specializes in IT services; call centers, business back-office operations and R&D.

Rapid growth in China has increased the local demand for consumer durables and nondurable, such as home appliances, electronics equipment, automobiles, housing and leisure. This rapid growth in local demand, as well as competitive business environment and infrastructure, has attracted many market-seeking investors. It has also encouraged the growth of many local indigenous firms that support manufacturing. Other determinants related to FDI attitudes, policies and procedures also explain why China does better in attracting FDI. China has "more business-oriented" and more FDI –friendly policies than India (AT Kearney 2001). China's FDI procedures are easier, and decisions can be taken rapidly.

China has more flexible labour laws, a better labour climate and better entry and exit procedures for business (CUTS 2003). A present business environment survey indicated that China is more attractive than India in the macroeconomic environment, market opportunities and policy towards FDI. India scored better on the political environment, taxes and financing (EIU2003a). In India the Government has planned to open some more industries for FDI and further relax the foreign equity ownership ceiling (EIU 2003a). To identify approaches to increase FDI flows, the Planning Commission established a steering committee on FDI in August 2001. Following the Chinese model, India recently took steps to establish special economic zones. China's special economic zones have been more successful than Indian export processing zones in promoting trade and attracting FDI (Bhalla 2002)

Both China and India are good candidates for the relocation of labour intensive activities by TNCs, a major factor in the growth of Chinese exports. In India, however, this has been primarily in services, notably information and communication technology. Indeed, almost all major United States and European information technology firms are in India, mostly in Bangalore. Companies such as American Express, British Airways, Conseco, Dell Computer and GE Capital have their back-office operation in India. Other companies such as Amazons Com and Citigroup outsource services to local or foreign

companies already established in the country. Investor's sentiment on China as a location for investment is improving. Nearly 80% of all Fortune 500 companies are in China, while 37% of the Fortune 500 outsource of India (NASSCOM 2001). Despite the improvement, TNC investment interest remains lukewarm, with

Table.3. China and India: selected FDI indicators, 1990, 2000-2002

Item	Country	1990	2000	2001	2002
FDI inflows (Million dollars)	**China**	3487	40772	46846	52700
	India	379	4029	6131	5518
Inward FDI stock(Million dollars)	**China**	24762	348346	395192	447892
	India	1961	29876	36007	41525
Growth of FDI inflows (annual,%)	**China**	2.8	1.1	14.9	12.5
	India	-6.1	16.1	52.2	-10.0
FDI stock as percentage of GDP (%)	**China**	7.0	32.3	33.2	36.2
	India	0.6	6.5	7.4	8.3
FDI flows as percentage of gross fixed capital formation (%)	**China**	3.5	10.3	10.5	N.A
	India	0.5	4.0	5.8	
FDI flows per capita (Dollars)	**China**	3.0	32.0	36.5	40.7
	India	0.4	4.0	6.0	5.3
Share of foreign affiliates in total exports (%)	**China**	12.6	47.9	50.0	NA
	India	4.5	NA	NA	
GDP (billion dollars) a	**China**	388	1080	1159.1	1237.2
	India	311	463	484	502
Real GDP growth (%)	**China**	3.8	8.0	7.3	8.0
	India	6.0	5.4	4.2	4.9

Source: UNCTAD, FDI/TNC database; IMF, World Economic Outlook Database, April 2003.

some exceptions, such as in information and communication technology (AT Kearney 2001).

The prospects for FDI flows to China and India are promising, assuming that both countries want to accord FDI a role in their development process- a sovereign decision.

The large market size and potential, the skilled labour force and the low wage cost will remain key attractions. China will continue to be a magnet of FDI flows and India's biggest competitor. But, FDI flows to India are set to rise-helped by a vibrant domestic enterprise sector and if policy reforms continue and the Government is committed to the objective of attracting FDI flows to the country.

Towards a strategic FDI policy:

Liberalization of norms relating to FDI and adoption of a policy stance supportive of globalization do not by themselves ensure that the economy would attain a high growth path. On the contrary, such policies could, in fact, be inimical to the long term development process of the country in the absence of 'safeguards'. If FDI is to be utilized for sustaining growth process of a country, it is essential to create local technological capabilities. The success of an industry in a globalize scenario hinges on its capacity to effectively cope with technical change. Skill development, industrial specialization, enterprise learning and industrial restructuring lead to improvement in productivity and help industries to cope with technical change. In order to create such processes within an economy, the Government may need to formulate a strategic FDI policy. A strategic FDI policy entails Govt. intervention in factor markets in order to develop local skills and to target FDI in areas where the country has dynamic comparative advantage (UNCTAD, 2003). The policy of the Govt. should be aimed at reducing macro level ineffectiveness and improving micro level conditions. The Govt. should be an effective regulator, being neutral to domestic and foreign capital.

The effectiveness of a strategic FDI policy is, however, is not much in significance now and it is almost a settled issue. Still, some studies suggest that Government intervention aimed at affecting FDI flows is at best ineffective and could be counterproductive. It is observed that direct foreign investors were not included by incentives such as tax concessions or strengthening the economic fundamentals of the host economy included FDI inflows. It has also been argued that industrial policies that seek to direct foreign investment flows towards certain sectors only distort the normal functioning of the market. While such measures do not include FDI, these can have serious negative implications in the form of reduced competition and creation of excess capacity in certain sectors (Mc Kinsey Global Institute, 2003). The motivation and determinants of FDI differ among countries and across economic sectors. These factors include (a) the policy framework such as, international trade and investment agreements, trade policy (tariff and non tariff barriers) and coherence of FDI policies etc. (b) the extent of business facilitation and other economic determinants such as macroeconomic fundamentals like; market size and per capita income, access to regional and global markets etc. and availability of infrastructure like; raw materials, low-cost unskilled labour, skilled labour , technological, innovative and other creative assets, (i e. brand names) including as embodied in individuals firms and clusters, physical infrastructure (ports, roads, power, telecommunication) , and (c) business facilitation such as; investment promotion (including image-building and investment-generating activities and investment facilitation services), investment incentives, hassle costs (corruption, administrative efficiency, etc.), social amenities (bilingual schools, quality of life, etc.), alternate investment services.

The Emerging Challenges:

Transnational Corporations (TNCs) can contribute more to advancing the development impact of their investment in developing countries, as part of good corporate citizenship responsibilities, whether through voluntary action or more legally based processes. Areas particularly important from a development perspective are contributing fully to public revenues of host countries; creating and upgrading linkages with local enterprises; creating employment opportunities; raising local skill levels; and transferring technology. These issues are all complex. Because the potential implications of some provisions in IIAs are not fully known, it is not easy for individual countries to make the right choices. The complexities and sensitivities are illustrated by the experience of NAFTA for the regional level; that of the MAI negotiations for the interregional level and that of the GATS and the TRIMs Agreement for the multilateral level. Given the evolving nature of II As, other complexities tend to arise in applying and interpreting agreements. Indeed, disputes may arise from these processes, and their outcome is often hard to predict. That is why Governments need to ensure that such difficulties are kept to a minimum. How? By including appropriate safeguards at the outset to clarify the range of special and differential rights and qualifications of obligations that developing country parties might enjoy. Moreover, the administrative burden arising from new commitments at the international level is likely to weigh disportionately on developing countries especially the least developed, because they often lack the human and financial resources needed to implement agreements. This underlines the importance of capacity –building technical cooperation to help developing countries assess better various policy options before entering new agreements and in implementing the commitments made. The overriding challenge for countries is to find a development – oriented balance when negotiating the objectives, content, structure, and implementation of future II As at whatever level and in whatever context. The development dimension has to be an integral part of international investment agreements-in support of national policies to attract more FDI and to benefit more from it.

The most important challenge for developing countries in future about International Investment Agreements (IIAs) is to increase FDI flows and the ability of countries to pursue development –oriented FDI policies –as an expression of their right to regulate in the public interests. This requires maintaining sufficient policy space to give governments the flexibility to use such policies within the framework of the obligations established by the IIAs to they are parties. The tension this creates is obvious. Too much policy space impairs the value of international obligations. Too stringent obligations overly constrain the national policy space. Funding a development –oriented balance is the challenge. When negotiating IIAs, the objectives of IIAs, their structure, content and implementation is addressed. Their content is central as the quest for a development friendly balance plays itself out in the resolution of issues that are particularly important for the ability of countries to pursue development –oriented national FDI policies and that are particularly sensitive in international investment negotiations, because countries have diverging views about them in light of their own predominating objectives.

From a development perspective, the most important issues are: the definition of “investment”, because it determines the scope and reach of the substantive provisions of an agreement; the scope of national treatment (especially as it relates to the right of establishment), because it determines how much and in which ways preference can be given to domestic enterprises; the circumstances under which government policies should

be regarded as regulatory takings, because this involves testing the boundary line between the legitimate right to regulate and the rights of private property owners; the scope of dispute settlement, because this raises the question of involvement of non-State actors and the extent to which the settlement of investment disputes is self- contained and the use performance requirements, incentives, transfer-of- technology policies and competition policy, because they can advance development objectives. For each of the issues, more development friendly and less development friendly solutions exits. From the perspective of many developing countries, the preferable approach is therefore a broad GATS-type positive list approach that allows each country to determine for itself for which of these issues to commit itself to in II As, under what conditions, and at what pace, commensurate with its individual needs and circumstances. In pursuit of an overall balance, furthermore, future IIAs needs to pay more attention to commitments by home countries. In fact, all developed countries (the main home countries), out of their own self-interest, already have various measures to encourage FDI flows to developing countries, in place. And a number of bilateral and regional agreements contain commitments. Developing countries would benefit from making home country measures more transparent, stable and predictable in future IIAs.

The overriding challenge for countries is to find a development – oriented balance when negotiating the objectives, content, structure, and implementation of future II As at whatever level and in whatever context. The development dimension has to be an integral part of international investment agreements-in support of national policies to attract more FDI and to benefit more from it. Most developing countries consider FDI as an important channel for accessing resources for economic development. FDI represents transfer of a bundle of assets like capital, technology, access to exports markets, skills and management techniques and modern environmental management systems.

Conclusion:

There has been significant liberalization of FDI policies over the past decade. Still. FDI is only a complement to domestic investment and even when inflows rose, the development benefits of FDI often below expectations of recipient domestic country. In essence, the actual impact of capital flows on economic growth is undoubtedly an empirical issue and varies widely across countries. An increase in capital flows is expected to augment domestic saving/ investment, boost aggregate demand and lead to an increase in aggregate output/income. At the same time, capital flows induced appreciation of exchange rate could adversely affect exports and increase imports thereby dampening the impact on aggregate demand and lead to deterioration in the current account. The policy response to the loss of external competitiveness may entail a softer interest rate environment to prevent appreciation of the exchange rate and to strengthen growth prospects.

Notwithstanding their potentially favorable impact on growth prospects, highly volatile nature of capital flows, especially portfolio flows and short-term debt, underscores the need for efficient management of these flows. While managing capital flows, clear distribution should be made between debts and non –debt creating flows, private and official flows and short –term and long –term capital flows. An overbearing objective of external sector policies of developing countries has been to devise strategies so as to maximize the benefits of capital inflows while limiting their adverse impact. At an individual country level, an appropriate response would be to build a resilient and robust

financial sector which could appropriately intermediate large capital flows. It is imperative that such capital flows are absorbed smoothly in real sector embodying growth impulses. Adoption of proper macro economic policies, particularly in respect of exchange rate management and monetary stance also assumes significance in dealing with large capital flows.

The experience of the Asian crisis revealed that large and volatile capital flows influenced the exchange rates and interest rates, leading thereby, to overshooting of exchange rates in some cases as expectations and reactions to news drove capital flows and exchange rates often out of alignment with fundamentals. Policy makers in developing countries, therefore, have to mange their capital accounts to ensure an orderly process of liberalization. The success of policy would lie essentially in managing the flows to reduce their volatility and limit their negative impact while reaping the benefits of such flows to enhance growth prospects of the economy.

To conclude, the need for a strategic FDI policy depends on several issues, because, once an enabling framework has been established, economic factors-the main determinants of FDI flows-assert themselves the extent of capital flows. On the contrary, host countries may not have the size of markets, growth rates, capabilities or infrastructure that would make investment in productive capacity attractive-either for the domestic market or as export base. Foreign investors may not have been well informed of the opportunities available-perhaps because host countries did not promote themselves effectively in an intensely competitive world market for FDI or were ambiguous about how much FDI they really wanted and on what terms.Hoever,from a development perspective, the most important issues are: the definition of “investment”, because it determines the scope and reach of the substantive provisions of an agreement; the scope of national treatment (especially as it relates to the right of establishment), because it determines how much and in which ways preference can be given to domestic enterprises; the circumstances under which government policies should be regarded as regulatory takings, because this involves testing the boundary line between the legitimate right to regulate and the rights of private property owners; the scope of dispute settlement, because this raises the question of involvement of non-State actors and the extent to which the settlement of investment disputes is self- contained and the use performance requirements, incentives, transfer-of- technology policies and competition policy, because they can advance development objectives.

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